Castling
Financial Planning, Ltd.

Helping You Secure Your Future™

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Fall 2016 Newsletter:

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The Secret Sauce is Confidence...and You My Dear, Seem to be Lacking It

Do we recognize confidence when we see it? What about the lack of confidence? How could we tell? Consider the following quote:

"Look, I'm just not ready to ask Lorraine out to the dance, and not you, or anybody else on this planet is gonna make me change my mind."[1]

The character George McFly said these words in the famous 1985 film, "***Back to the Future***". A good part of the movie was about how his future son to be, Marty McFly, helps him gain the confidence to take the steps that will change his life around.

Clearly, confidence leads to action. Whether that action proves successful or not, that's quite another matter. By contrast, would not the lack of action epitomize a lack of confidence?

There is a somewhat unconventional way to tie this back to the US economy. After demonstrating this, we layer in our favorite topic, financial planning, to begin the discussion on how we can harness the future economic cycle we believe, will follow this one.

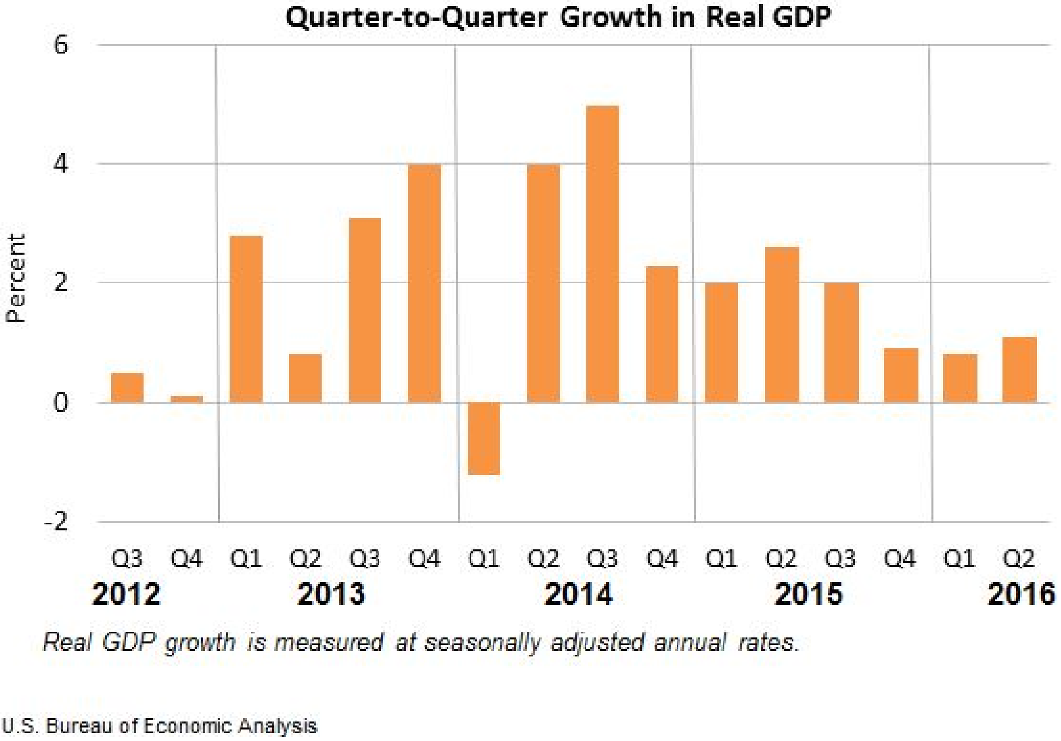
Most all of us have heard or read about measures of economic growth. The **Gross Domestic Product** (GDP) is the broadest measure of the amount of goods and services produced within the US, over a calendar year period. There is much hand wringing and gesticulating around the direction and magnitude of changes in the GDP. Two negative quarters of change in a row, constitutes the technical definition of a recession.

But relatively few people dwell on the absolute dollar amount (called nominal GDP), which currently measures more than $18 trillion. The main reason is that inflation distorts its meaning. In other words, if inflation resulted in the price of widgets increasing from $1 to $2, an economy producing only widgets and always the same number of widgets from year to year, would appear to be twice as big. But since inflation is just an increase in the price level, we see that nothing more of value has actually been created.

Economists resolved this issue by creating an inflation adjusted gross domestic product, or "real GDP". It provides a more accurate measure of growth[2].

On top of this, the percentage change from quarter to quarter or year to year, is measured. This provides an easy to grasp view into economic growth. The Bureau of Economic

Analysis (bea.gov) is responsible for its calculation. They produce highly readable charts such as the following[3]:



We don't see any recession (although there was one negative quarter back in 2014). But an obvious drop in economic growth over the time period, is evident in the chart.

So if inflation needed to be backed out of nominal GDP to make it a more accurate measure of our economy, what else could also be backed out, to arrive at something that more closely measures confidence (or lack thereof)?

Our thinking is straightforward, perhaps somewhat simplistic. If there is another mouth to feed, a person to clothe, house and take care of, then wouldn't we naturally expect the economy to grow by at least the net growth rate of the population? So we decided to look at population growth, which has tended to fall within a rather narrow range close to 1% per year. A growing population could mean a prosperous nation, but it does not necessarily mean that existing citizens or residents are feeling more confident. Let's back out population growth from real GDP growth[4].

But we're not quite finished, so let's recap. We have adjusted for inflation, since producing a widget now costing $2, that used to be a buck, does not mean that our economy is actually growing. Furthermore, just because there is net positive immigration and there are more births than deaths, this does not mean that the economic "participants" (you and I) are any more confident in our actions. Therefore, we back out population changes from real GDP growth.

The final issue we touch upon deals with how much effort it takes to produce that widget. Let's suppose that technological breakthroughs result in twice as many widgets being produced by the same set of workers. There is no denying that this is a benefit to the economy. But if more can be done with the same, why couldn't the same be done with fewer? In other words, we consider productivity changes. Producing more with fewer inputs does bring up the downside of potential layoffs.

We expect that technological progress works in one direction. We either continue doing what we have been, or upgrade to the next level. We don't say that we're dumping our laptops and printers in favor of going back to the good old IBM Selectric typewriter. If we do upgrade, do we always consider this the result of confidence in ourselves or the economy? Hardly.

So let's back out productivity growth from real GDP growth, using data supplied by the Bureau of Labor Statistics[5].

At this point, it may be useful to review what GDP is all about. Our contention is that it's all about transactions. You and I could be sitting on a park bench discussing a utopia of one form or another. But unless we trade with others, nothing happens. The economy is measured by transactions.

Each transaction represents some level of decision making by the buyer and seller. Do I take this deal or not? What if something better comes along? Can I afford it? Do I really want this? Do I need it? Should we build the new widget factory in Timbuktu or in-source it to the US? How many widgets should we plan to produce? If we make them, will customers buy? OK, so what was that corporate tax rate in Timbuktu again?

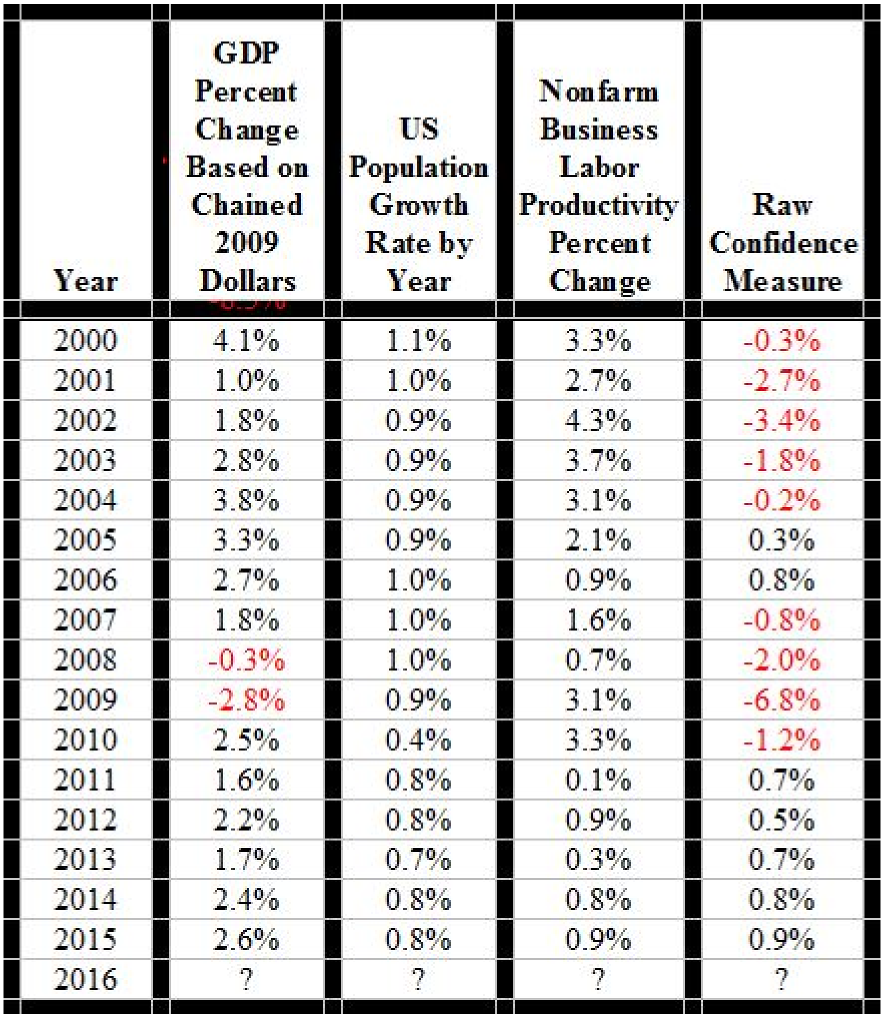
The larger the purchase, the more that confidence plays into our decision making process. Will I still have a job next year? Will my spouse's bonus be cut again this year?

Our contention is that economic growth due to confidence is one of the major drivers of the economy. This confidence needs to manifest itself at two levels: both at the micro and macro levels. (We are not referring to the $GDP = C + I + G + NE$ formula, either.)

At the micro level, we see all the specific, individual decision points about whether a good or service is the right one for us, or if it is the best fit or is being sold for the best price, at the right terms, etc. But at the macro level, how many times have we simply pulled back from a purchase commitment because we didn't feel it was the right time? The economy is too uncertain, we may have thought. What if I lose my job?

If enough confidence remains at our micro and macro levels, it still takes two to tango. The seller on the other side of the transaction, whether she is the owner of a boutique apparel shop that depends greatly on its customers having large amounts of disposable income, or a large department store deciding on whether to go ahead with a promotional campaign, has to be willing to transact with our newly confident buyer.

But all has not been well recently. The US economy has been experiencing a very slow period of growth that is clearly below the long term +3% GDP trend line. This is on top of the fact that the ground lost during the last recession has not really been made up. We need above trend line growth, in order to get back on the trend line. Confidence is lacking. Now, let's look at how our calculations turned out over the past sixteen years.

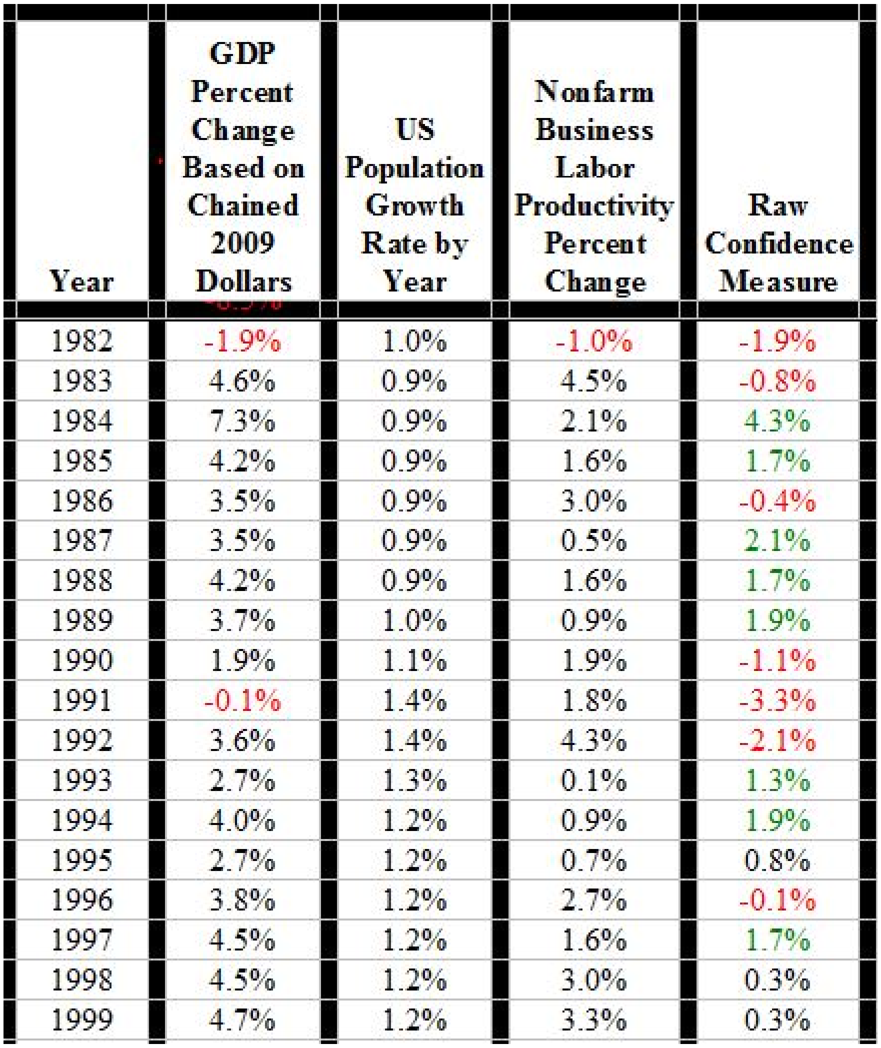


Year	GDP Percent Change Based on Chained 2009 Dollars	US Population Growth Rate by Year	Nonfarm Business Labor Productivity Percent Change	Raw Confidence Measure
2000	4.1%	1.1%	3.3%	-0.3%
2001	1.0%	1.0%	2.7%	-2.7%
2002	1.8%	0.9%	4.3%	-3.4%
2003	2.8%	0.9%	3.7%	-1.8%
2004	3.8%	0.9%	3.1%	-0.2%
2005	3.3%	0.9%	2.1%	0.3%
2006	2.7%	1.0%	0.9%	0.8%
2007	1.8%	1.0%	1.6%	-0.8%
2008	-0.3%	1.0%	0.7%	-2.0%
2009	-2.8%	0.9%	3.1%	-6.8%
2010	2.5%	0.4%	3.3%	-1.2%
2011	1.6%	0.8%	0.1%	0.7%
2012	2.2%	0.8%	0.9%	0.5%
2013	1.7%	0.7%	0.3%	0.7%
2014	2.4%	0.8%	0.8%	0.8%
2015	2.6%	0.8%	0.9%	0.9%
2016	?	?	?	?

Not enough data points for 2016 were available to make a meaningful estimate. GDP growth has been about 1%. Potentially it could be 2% for the full year, at best. Recent productivity numbers have been awful, perhaps reflecting a lack of capital investment.

What was more surprising to us was the long term, persistently poor performance of our **Raw Confidence Measure** (the last column). "*A 21st century tour de farce*". A negative number is shown in red and represents a confidence deficit. The only positive numbers are all under 1.0% for this period. The general perception of this time has been rather gloomy. So, we take 1.0%+ as a cut-off between having measurable confidence and 0-1.0% as being only marginally confident.

We may then ask, was it always this way? For comparisons sake, we went back to 1982-1999.



Year	GDP Percent Change Based on Chained 2009 Dollars	US Population Growth Rate by Year	Nonfarm Business Labor Productivity Percent Change	Raw Confidence Measure
1982	-1.9%	1.0%	-1.0%	-1.9%
1983	4.6%	0.9%	4.5%	-0.8%
1984	7.3%	0.9%	2.1%	4.3%
1985	4.2%	0.9%	1.6%	1.7%
1986	3.5%	0.9%	3.0%	-0.4%
1987	3.5%	0.9%	0.5%	2.1%
1988	4.2%	0.9%	1.6%	1.7%
1989	3.7%	1.0%	0.9%	1.9%
1990	1.9%	1.1%	1.9%	-1.1%
1991	-0.1%	1.4%	1.8%	-3.3%
1992	3.6%	1.4%	4.3%	-2.1%
1993	2.7%	1.3%	0.1%	1.3%
1994	4.0%	1.2%	0.9%	1.9%
1995	2.7%	1.2%	0.7%	0.8%
1996	3.8%	1.2%	2.7%	-0.1%
1997	4.5%	1.2%	1.6%	1.7%
1998	4.5%	1.2%	3.0%	0.3%
1999	4.7%	1.2%	3.3%	0.3%

Any values above 1.0% we highlighted in green. We contend that these are among the most confident years, purely based upon the actions of everyone in the economy.

We find the following to be our rather interesting conclusions:

1. The 1991 recession was in reality, rather shallow. At the time, public confidence in then President Bush the elder, seemed to slip away. If you look at our raw confidence numbers, this now seems pretty clear (1991 and 1992 were pretty poor). The economy was improving in 1992, but it was too little, too late. There were high population and high productivity growth rates. However, many people were on the economic sidelines, either by choice or by necessity.
2. The Great Recession of 2008-2009 seemed to last longer, according to some folks. Our measurements show that confidence was poor going into 2008 and then fell off a cliff. Fewer employees were involved in producing good and services, as they got stretched ever more thinly. From a confidence standpoint, the recession seemed to last longer than the pure GDP numbers would tell.
3. The 1980s appear to be the time period of the last major, sustained period of raw confidence, once the 1982 recession was over and some initial productivity gains were achieved. For example, there was a stock market crash in 1987. Did it lead to another Great Depression? *Nope*. A new recession? *Nyet*. Instead, confidence remained at a relatively high level.
4. We have not experienced a year of true "raw confidence" since 1997 (+1.7%). This is perhaps most surprising. Productivity improvements, probably due to Y2K, were coming online consistently during the late 1990s. The economy was growing robustly, but it does not appear that this was due mostly to raw confidence. Our view has been that Y2K was the catalyst that helped propel the economy for a time, only to cause a recession by early 2001. At the same time, many had already modified their behavior, believing "it's different this time".

We have tried to highlight the importance of confidence in the economy and have offered a simple approach for separating population growth and productivity gains (two factors that we feel are obscuring the raw confidence embedded in the economy's growth numbers), from real GDP growth.

The economy is still stuck in low gear. The current expansion that began in July, 2009, appears to be the third longest in the past 100 years. But since it is now more than seven years old, we think a recession is somewhere around the corner. We cannot tell if this means within the next 12 months or 48 months. We shy away from event level prediction. We can say that the millennial generation, being both quite large as well as "financially delayed" in achieving the same goals as prior generations, will be the ones to watch. But this may require a new economic cycle. In other words, the recovery beyond the next recession. We will continue reporting our analysis in future issues. Stay tuned.

Match Maker, Match Maker, Find Me a Match...What, You Expect Me to Choose This "Tool"?

In accounting, there is a matching principle that expenses are to be linked to the revenues they helped to create. We'll spare the reader the gory details. There is also a matching principle among tradespeople, that one should “pick the right tool for the job”. But somewhere along the way, this same principle in financial planning seems to have been lost to the general public. Or at least that's how it appears to us. Why? How can we fix this situation?

My earliest recollection of the failure to adhere to the “right tool for the job” matching principle occurred back in 1987, as I watched TV reports on the aftermath of the sudden stock market crash. A couple were explaining to the reporter how they had lost a good chunk of their down payment for their first home. I was a young and very inexperienced investor at the time. They admitted that perhaps keeping money in the stock market that needed to be withdrawn within a short time, was not the best idea in the first place. Back then, one year bank CDs paid positive, risk free returns, after accounting for inflation. Clearly, the equity markets, or stock mutual funds, were not the right “tools” for this particular “job”.

Many times we have seen commission based product salespeople (CBPS) advising clients to purchase some form of indexed annuity, apparently because it paid them huge commissions. But some of these clients were elderly. These annuities often came with very long surrender charge periods, sometimes lasting more than a decade. This made it more costly for the senior to access their funds, precisely when they needed the money most. But the CBPS may have portrayed himself as being their trusted advisor.

Some young people have been fooled into thinking that it was in their interest to build their credit history, by piling on debt at an early age. Instead of a low limit store card with only a few disciplined purchases, it turned out to be a smorgasbord of spending, because the card was just so easy to use. Right tool for the job, or just another fool with a tool?

Matching the right tool for a given job has often meant that the size, scope, value and complexity of the task were taken into consideration first. A fifty dollar solution to a five dollar problem is not really a solution at all, but just another problem in disguise.

This is no different in financial planning. The idea should be to reach for the simplest and lowest cost solution that has the mandatory attributes we need to resolve the issue at hand. Matching a solution to a problem, an asset with a liability, an asset allocation with an investment horizon, a target date with a bond's maturity, etc. is the financial planning equivalent to Occam's razor. Simply stated, this principle says that in solving a problem or explaining something where there are multiple possible causes, select the simplest[6].

Next, we select a number of areas where we associate a financial planning need with a potential solution, chosen based upon reference to our ***matching principle***.

"Making ends meet at the end of a month? No problem! That's what this here credit card is for."

$$$ - So how do we allocate our often scarce resources to meet our needs?

Many people resist doing a budget more than their pets resist getting a shampoo. Yet, we would be surprised if a large business or major non-profit organization operated without any form of budget. Part of the push back seems to be that this, like other planning tools, does not look like reality. But it can start very small and then become more complex and therefore, closer to the actual needs of a given family. The solution for too much month left at the end of your money, is to reevaluate where your money is going first. Next, determine what can be pared back and what can be eliminated all together. Increasing income through getting another job may work for some, especially younger people. But this may just be masking deeper problems, such as a spendthrift mentality, a permanently low primary income (perhaps due to the lack of marketable skills), or just plain envy (i.e. keeping up with the Joneses).

Action Item: Do a budget first and quantify where you stand. It will help you and your family reach your goals.

"The financial gurus told me I needed an 8 month emergency fund. So now I've had $50,000 earning 0.05% for the last 8 years! 'Just' 18 more years until retirement. What could possibly go wrong?"

$$$ - An emergency fund is part of your Savings Portfolio (which is separate from your Investment Portfolio). But should that require you to keep ALL your long term savings so liquid (to handle unplanned events), that you wind up losing purchasing power every year due to inflation?

Generally speaking, everyone needs an emergency fund. Certainly not everyone heeds this advice. We may actually see very few emergencies in our lives. But when we do, we need to make sure that enough funds are available and are liquid.

For most people, an amount equivalent to three to six months of after tax expenses, as calculated by your budget (remember that thing?), would be adequate for liquid savings. A suitable and safe savings vehicle is required for the textbook definition. Oftentimes, this means using a bank checking or savings account, money market fund, or short term bank CD (i.e. maturing in six months or less). Depending upon the predictability of one's income, the size of the emergency fund can then be adjusted. Three months may be appropriate for very stable households. Those with variability in income may need to carry much more.

But the blanket advice for everyone to keep enormous sums on tap, such as eight months worth in a low yielding vehicle, is more than overkill. It may be more like roadkill.

If this person or family lives in a home for which they are paying a mortgage and if they intend to live in that home for the indefinite future, a different alternative is available.

Yes, do keep some pure emergency funds. But begin to build long term savings by pre-paying your mortgage! You will earn a rate of return that matches the interest rate on the loan. You can start it up and shut it down very quickly, typically at zero additional cost. Remember that you are already performing “forced savings” with every single mortgage payment you make.

If you intend to remain living in your home, then the short term market fluctuations in its value are meaningless to you. However, you still need to keep paying your mortgage loan monthly.

So instead of adding $100 a month to an emergency fund which already covers three months of expenses, why not add this as additional principal to your 4% mortgage loan? You will then effectively earn 4%, by not paying 4% interest on that $100, from now until the end of the loan term. This is both higher than the current inflation rate, as well as much higher than comparable savings vehicles such as a long term bank CD.

Having a paid off home by or before retirement, is a huge benefit. We have discussed the details in previous newsletters.

How could we then “liquify” those pre-payments, should an emergency occur? This is done simply with a home equity line of credit (HELOC). Of course, there are interest costs to re-borrowing, but this depends upon the amount of money needed and the length of time it takes to repay those funds. True emergencies should be relatively rare, but when really needed, a HELOC can be accessed by simply writing a check. Just keep it locked up and out of mind, otherwise.

Action Item: Review your mortgage and determine if an automatic pre-payment schedule is right for you, instead of making your emergency fund gigantic.

"We got scared in 2008, so by the end of the year,we pulled everything we had left in the stock market. We were too cautious to get back in. Hey, I was only five years from retirement, what did you expect me to do?"

$$$ - Your investment portfolio could be likened to a sports team. There are multiple members, each having a specialized role to play. There should be a carefully created plan for not only asset allocation and asset diversification, but also for time horizon diversification, income planning and income tax optimization. Match different accounts or portions within an account (such as individual funds) to the various needs you will have.

We are not able to provide a full discussion on asset allocation right here. Instead, our point is that you can split apart your accounts (and individual investments within those accounts), on paper. This logical type of separation can be used to great benefit.

For example, suppose you plan to retire early from one career and go into something else, more fulfilling but lower in salary. Maybe it's just part-time. If you planned your exit well, you may like to make use of the "separation from service at age 55" exception to the 10% early withdrawal penalty (pre-age 59-1/2), that applies to qualified plans such as a 401(k). This exception does not apply to an IRA.

We can allocate the funds we will need over the next several years (during our second career) and move them to a Stable Value fund (which your 401(k) may have). Stable Value is not available in IRAs. While they are not high yielding, they do provide better returns than money market funds.

For some of the other funds in your 401(k), you may decide to invest for growth, based on a plan for not touching them for the next 25 years (with the exception of required minimum distributions (RMDs), if applicable). While this may seem excessive, it's based upon the idea of a ***longevity portfolio***. If you live a very long time, you will need more assets. Therefore, those assets need an environment in which they can grow in the interim. This means that they may oscillate wildly during a time you would not like them to. But remember that's OK if you don't plan on needing those assets for a long time.

A third part of your 401(k) assets may be targeted for the time in the middle, such as growth and income. This is not meant to be for the next few years, but it's also not for your 80s. Therefore, the risk tolerances for this portion of your portfolio would result in not depending solely on either fixed income, nor solely on growth. These risk tolerances may mean some version of 40/60 to 60/40 equities. For very conservative investors, we suggest you look into our ***Castling Defensive Portfolio*** (CDP).

As a result, the next market correction, or even bear market, should not make you feel as though you may wind up losing everything. No need for a panic attack.

These are merely suggestions. The specific plan is something that needs detailed analysis between you and your financial planner.

Action Item: Map out a time line for yourself/spouse and match it to available assets. Logically split apart accounts (on paper) and plan for having enough assets with stable values when you need to access them first. Allow some investments to be allocated for growth, for your old age. Other assets fall somewhere in between. Seek out professional help as may be appropriate.

"The agent told me that cash value life insurance was the way to save for junior's college fund. For our older daughter, we used an UGMA. When she became an adult, she cashed it in to buy her new boyfriend a Harley. No sir-ee Bob. We're not making the same mistake with junior. Whole Life. That's what I'm talkin about!"

$$$ - College is crazy expensive. It may not even be worthwhile in every single case. Saving for college should not come at the expense of your retirement investing or home mortgage pay down. But matching multiple "tools" here is important. Part of this should be your child's responsibility: getting an education that teaches skills that someone is willing to pay them to use. Finishing in four years. Focusing on the "right major", not the "right school". Investigating all potential scholarships and grant money. So save up what you can, by using a Section 529 plan. Do not feel limited to only using the 529 plans in your own state, although be aware that there may be state income tax benefits. Go for growth in the investments if you have ten years or more before your child starts school. Your child is the beneficiary, but not the owner, of the plan. If grandparents, other relatives or friends are involved, have them open separate 529 plans. If there is even a ghost of a chance for more financial aid, have them use themselves as the beneficiaries until late in the game.

A full discussion of 529 plans is well beyond our scope here. We merely highlight how many people have been lulled into thinking that some other tool was going to make college funding easier and cheaper.

We recommend that in solving such a large problem, we attack it in stages. Break it down into its constituent parts and get it into a form in which it is more easily dealt with.

1. The career is far more important than the school. Some colleges and universities are peddling an over priced, over hyped experience, instead of focusing on academics. The decision on a major, or general program, is more valuable. Why is so little time spent making sure it's the right one, while so much time is spent on selecting and applying to a school?
2. Applicable credits are valuable. Can your student gain them in cheaper venues, including junior and community college? The degree will still be issued from the big name school.
3. Focus on studies and not on attending parties. While seemingly obvious, a sizable portion of college debt seems to stem from not paying enough attention to academic matters that would result in graduating in four years. Outside employment during school may not be worth what it pays, especially if credit hours are accumulating too slowly.
4. How prudently is the student living while at college? Tuition is only one part of the problem. The focus should be in getting an education, not on attending a resort. This is another place for creating and using a budget. This time, the student's spending habits throughout the semester should be the focus.
5. Section 529 plans offer professionally managed portfolios, but may be changed only once every 12 months. Enough research needs to be undertaken to determine if your state's plan has a good enough provider and also offers enough tax incentives to stay with it. The best Website we know of for information on 529 plans is: SavingforCollege.com[7].
6. Section 529 plan assets grow tax deferred with earnings being free of income tax, if used for eligible expenses at accredited colleges and universities.
7. Your child is a beneficiary of a Section 529 plan account, but not its owner. The beneficiary may be changed, in case the young person decides against college. There is no age limit on opening or using 529 plan assets. Grandparents, relatives, friends of the family, even complete strangers can open a 529.
8. A parent's 529 plan assets are going to be included in financial aid calculations. Depending on the type of school, home equity and retirement plan assets may or may not be included in this determination.
9. If there is a chance at getting future financial aid, one strategy would be for grandparents or anyone else who opened a 529 to use someone else, including and especially themselves, as the named beneficiary. This may allow the student to qualify for aid, or for a larger aid package than they otherwise would be able to. Then after the last aid package has been secured, such as during junior year, ask the other parties to change their 529 plan beneficiary to your child. This is legal to do. It will truly help finance the senior year.

Action Item: The time to start thinking about college funding is probably when you first start thinking about having a family. (OK, we're kidding!) The Section 529 plan account is a finely matched tool to the job of college funding. Finding out enough information to become conversant in account opening and funding would be a good use of your time. Getting other family members to join in would be even better, if this would be possible. But 529s are not the only tool. Your child needs to help by figuring out what he or she would like to do with their life. Lastly, how prudently they walk through the process of the college years is important. Learn from others' examples, both good and not so good.

Home is Where the Horde (of Cash) is...or Should Be, In Retirement

One of our common themes has been the importance of investments and savings working together, but as two fundamentally different things. And one major component of savings is your primary residence, if you happen to own one. It should not be treated as an investment, since you (presumably) do not hold it out for the production of income. But you do receive the economic utility of having a roof over your head. Many clients figuring out how to get the mortgage paid off at or before retirement, is a worthwhile goal. So let's assume that this has been accomplished. Now what?

During retirement we have discussed in other articles, how the ***Castling*** principle works with both investment and savings portfolios, to cushion against market losses during down cycles. By drawing on savings, including home equity, you help to avoid depleting your investment portfolio too quickly. This allows it time to recoup itself and make up for the losses.

Here we are looking at general approaches for liquifying that home equity, the reasons to do so, the costs as well as the level of time and effort involved. But there is another aspect we introduce here: non-financial reasons. Oftentimes in dealing with clients, non-financial reasons are as important, if not more important, than pure dollars and cents.

Please refer to the table below. Highly summarized descriptions are given. The objective is to compare and contrast. No single solution is thought to be superior. They each depend upon the specific facts and circumstances for every person or couple.

Any retiree or soon to be retiree, should be able to look at this table and think about their own situation. Is my present home really suitable for me or my spouse, as we age? Are there stairs or doorways that could pose a challenge based upon deterioration of our present health? What would it take to solve these problems, or at least mitigate the adverse effects?

As painful as it may sound, the best answer for some folks will be to sell their present home and downsize into a residence which is more properly suited to their changing needs. This may free up more cash that could be devoted to the long term savings portfolio or to buy an annuity. If their investment portfolio already looks robust, then moving these funds into assets that also are subject to market risk, would not be such a good idea.

But selling your home is an expensive and time consuming proposition. Local market conditions may pose a challenge in realizing what you expect in a sales price. Beyond the

Action to Undertake	Typical Financial Reasons Why	Typical Non-Financial Reasons Why	Level of Cost Involved	Level of Effort Involved
Selling Home and Downsizing	Too expensive to maintain: repairs, maintenance and utilities	No need to keep the amount of living space	VERY HIGH	VERY HIGH
	Property taxes are too high	Present home has not been adapted to current physical limitations	Sales commission and closing costs of both sale and replacement purchase	Moving expenses and effort to schedule and conduct
Home Equity Line of Credit (HELOC)	Ability to draw on home equity for an emergency	Peace of mind in knowing that standby credit facility is available without any plans for drawing on it	LOW	LOW to MEDIUM
	Cushion against temporary fall in value of investment portfolio		Typically $0 upfront costs	Application may require time and effort to collect financial data
			Variable rate	Need to pay interest only during initial draw period
			Low annual maintenance costs of around $50	
Home Equity Conversion Mortgage (HECOM) aka Reverse Mortgage	Lack of other resources in retirement	Peace of mind in knowing that standby credit facility is available without any plans for drawing on it	VERY HIGH	MEDIUM
	Cushion against fall in value of investment portfolio		Upfront costs and typically more expensive than a conventional mortgage	Application may require time and effort to collect financial data
			Typically variable rate	Counseling from HUD approved agency required

sales commission and closing, there are costs involved in finding the replacement property, as well as with moving expenses and breakage. Although our anecdotal evidence is far from perfect, it has been our experience that a person or couple who is downsizing, may not "get it right" on the first try. This means that they wind up being unsatisfied in their new residence and move yet again, within a few short years.

When uncertainty seems high, it may mean that a period of renting would be useful, especially if it helps the folks to determine exactly what they are looking to purchase, where it may be located and for what price.

By contrast, the home equity line of credit (HELOC) may be one of the most useful tools we have found, still available for no upfront fees. But due to increased banking costs, it is now relatively rare to find a lender who will maintain a HELOC for absolutely zero cost. Some sort of annual maintenance fee, such as $50, is now required. However, getting this much for this little, is still genuinely a bargain.

A HELOC will require monthly interest only payments. Typically, a checking account can be set up at the lender's bank. An ACH debit can be set up that will pull the interest amount automatically from the checking account. This is very convenient. Furthermore, the initial payments for the HELOC in retirement, can be taken from the draw itself.

For example, let's suppose we need $10,000 to supplement our income while our investments have been down recently. We want to avoid depleting an already shrunken investment portfolio and give it more time to recoup itself. But let's further suppose that this investment portfolio is part of a traditional IRA. This means that each distribution is taxable income. So if we would have taken $10,000 from the IRA, we would have only $8,500 left after withholding 15% for income taxes. On the HELOC side, a draw on the equity line is not a taxable event. However, we do need to pay the interest costs until such time that we regain the value in our investments.

So guess what? We take out $10,000 from the HELOC and leave $1,500 in the checking account for future interest payments.

Let's suppose the interest rate on the HELOC is as follows:

4% in the first year
5% in the second year
6% in the third year

The interest payments would be as follows: $400, $500, $600, for a total of $1,500. We have given ourselves three years of slack in the hope that the investment portfolio rebounds and delivers outsized returns that allow us to repay the principal draw taken.

Of course, life does not always work so well. As a result, we may need to take further action if we do not have the funds to repay the HELOC after three years. It may even mean taking another draw on the credit line.

On the other hand, it could also result in moving toward another product, the home equity conversion mortgage (HECM), better known as a reverse mortgage. As we show in the above table, the reverse mortgage is very expensive in that there are usually mortgage origination and closing costs. However, these are somewhat hidden from sight and are usually not paid out of pocket. Keep in mind that just because a cost does not seem to get paid directly from your wallet, does not mean that it does not exist. Exit a HELOC after ten years of inactivity and you may just be out the $50 x 10 years of account maintenance fees, at most. Do the same with a HECM and you will find that you “have paid” much more, in terms of lost equity.

In addition, at least one HECM borrower must be age 62 or older. The reverse mortgage lender is paid back after the last remaining homeowner leaves. Until then, no payments are required, although they are permitted. In our scenario, the reverse mortgage is used to pay off the HELOC, which was used to cushion the owner's falling investment portfolio. This is just one use for a reverse mortgage. It may also be used as a standby line of credit, to provide monthly payments similar to an annuity, or even to purchase a retirement home, where the buyers are initially putting up more than 50% of the equity.

The reverse mortgage lender will want to have the first lien position, so any other mortgage debt, such as a HELOC, will be eliminated. Taking out a reverse mortgage implies continuing the standard practices of maintaining the house, paying real estate taxes and keeping adequate homeowners property insurance.

While laws regulating reverse mortgages have changed somewhat in the past few years, the bottom line to remember is that the government (FHA) guarantee ultimately protects the lender and not you, the homeowner. We call it a “terminal product” for that particular home. This is not meant to denigrate it. When used properly as part of an overall retirement income plan, a reverse mortgage can be a very useful tool.

Each of the three major alternatives we discussed to “liquifying home equity” has its own pluses and minuses. A combination approach over the course of a couple's retirement may be the optimal solution. This may involve downsizing/relocating, getting a HELOC to start with and then finishing with a HECM, when and as needed.

Taking Your Lumps (Lump Sum, that is) and Rethinking Income Generation in Retirement

Historically speaking, 1981 was one heck of a year to annuitize a lump sum pension distribution. Why? Interest rates were still sky high, but were about to drop dramatically. Today, interest rates are currently near historical lows. So by comparison, what does that mean for annuitizing a lump sum in today's environment? Not too great. Please keep this in mind as you read the following.

Pension plans and insurance companies face massive problems in funding future liabilities. Their investment portfolios have not always been generating the returns that were expected. However, promises that need to be kept are usually very specific. An employee participant works a certain number of hours, such as 1,000 to 2,000 and is credited with a year of service (YOS). If their employer still maintains a defined benefit pension, detailed rules govern how wages and YOS translate into a future pension benefit, assuming vesting (making the benefit a certainty) occurs. The pension plan administrators are supposed to analyze the benefit accruals that are to happen in the upcoming year, along with the present value of future payments and determine if this is matched by the current size of the pension trust fund, along with the current year employer contributions.

Things have not been going very well in the defined benefit pension arena lately. Some employers have terminated their plans. Others have frozen theirs in place, so that employees would not accrue further pension credits.

Meanwhile, cash balance pension plans have become more popular. These show a hypothetical account balance to an employee participant. Assuming she is already vested, the employee could leave her employer tomorrow with X dollars, which could be rolled over into a traditional IRA, income tax deferred. Or maybe not. The participant retiree may be offered a monthly pension payment of Y dollars for the rest of her life, or some lesser amount with joint and survivor benefits.

Some employers who maintain a traditional defined benefit pension may also offer departing employees a lump sum alternative. So there is a choice of “taking your lumps” now, or getting a fixed check (which is almost never inflation adjusted) monthly, for the rest of your life, or the lives of you and your beneficiary.

Thirty years ago, the idea of just about anyone taking this lump sum pension distribution and then either banking or investing it, were viewed as credible alternatives to getting a monthly check.

Let's create a scenario where we attach some numbers to these concepts. Assume the lump sum distribution for a 55 year old departing, low level executive, technical or professional employee, is: $250,000. Out the door. Goodbye. Arrivederci. Don't let the door hit... I think you know what we mean.

The alternative monthly, fixed pension is set at $1,600. This assumes 100% joint and survivor (J&S) benefits. In other words, the monthly check stops only after the second beneficiary dies. We recommend that anyone performing this analysis always uses the 100% J&S amount. The reason is that anyone who takes the lump sum will be able to leave it to their spouse or other beneficiay. It would simply not be actuarily or financially equivalent to compare a single life amount to a lump sum. Notwithstanding, $1,600 in today's environment is biased to the up side. In reality, it could actually be lower.

To prove this, we used the very useful ***ImmediateAnnuities*** Website to check out a 55/55 year old couple with $250,000 ready to buy an immediate annuity with 100% survivor benefits. The best estimated quote was under $1,000[8], much worse than our pension.

Thirty years ago, three early retirees choosing the lump sum option may have envisioned the following major alternatives that they could select from:

1. Put the entire lump sum in bank CDs averaging 7%. The more sophisticated person would have created a laddered CD portfolio going from short term vehicles, such as 6 month certificates and extending out to 5 years, for example. Let's assume the average weighted yield was 7%. The annual income generated was $17,500, or $1,458.33 monthly. Because these are CDs, this exact interest amount may not have been available every month. Our retiree may have told the bank to deposit his interest payments as they came due, into his checking account. In any event, he was “happy as a clam” because even though this amount is less than his quoted monthly pension alternative, he still gets to keep the $250,000. He prides himself as “living off the interest”.
2. Put the entire lump sum into a portfolio of US Treasury and high-grade corporate bonds, with an average weighted yield of 8%. Again, a more sophisticated person would have created a laddered bond portfolio for both the Treasury and Corporate sides, going from short term bills to medium term notes and longer term bonds. The annual income generated was $20,000, or $1,666.67 monthly. Because bonds usually pay interest semiannually, this exact interest amount would not have been available every month. But our retiree is “happier than a clam”. The amount is greater than his quoted monthly pension alternative and he still gets to keep the $250,000. He also thinks of himself as “living off the interest”.
3. Put the entire lump sum into an investment portfolio allocated about 60% to equities and 40% to bonds The expected rate of return in that age would have

been at least 8%. Let's suppose the investor had heard of the so-called "4% rule" and decided to begin annual withdrawals with 4% of $250,000 or $10,000. This amounted to $833.33 per month. This investor is also quite happy with his choice, since he would have been adjusting his withdrawals for inflation. He started out very low, but ratcheted up each year. This is something that the other two could not do.

While the above approaches looked feasible three decades ago, the present environment tells a different and much bleaker tale.

1. The bank CD portfolio may provide a weighted yield of 1.5%. This translates into just $3,750 annually, or $312.50 per month. The monthly income is more than 75% lower! This amount will likely not even pay for food.
2. The bond portfolio fares only slightly better. Let's be generous and assume a 2% weighted average yield. This means $5,000 annually, or only $416.67 monthly.
3. The investment portfolio may pull in 7% average returns (down from 8%, at least), but our investor may be somewhat more gun shy, given the two bear markets he would have experienced over the past 16 years.

So what is to be done today?

For many people for whom this $250,000 lump sum would be their ONLY $250,000 sum (not counting the value of their primary residence or Social Security benefits), the only feasible answer may be to take the monthly pension benefit and forget the lump sum. If the age 55 J&S pension is indeed $1,600, as compared to a $250,000 lump sum, then we say take the pension.

On the other hand, if the pension amount is significantly less than $1,600 versus a $250,000 lump sum, you may still need to take it, if you have very low risk tolerances.

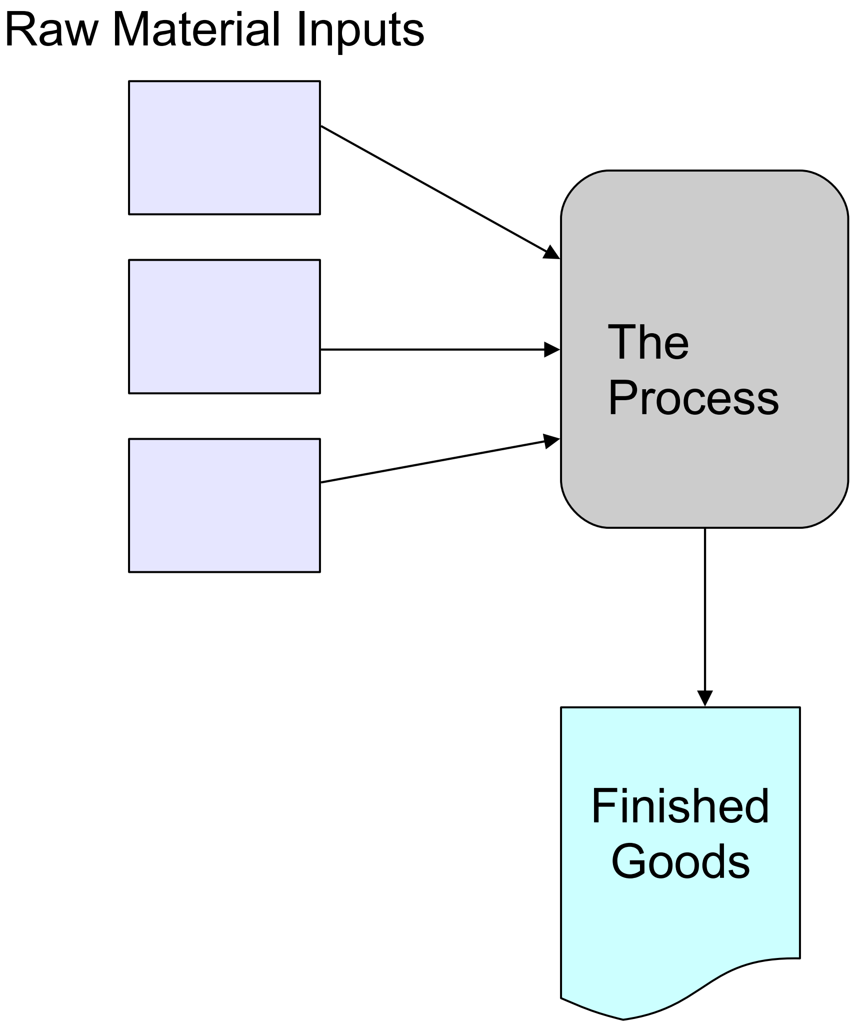
But what if this $250K, if you accepted it, was NOT the last and only $250K in your life? What if you already had an investment portfolio, other savings, spouse's accounts, etc? Could you then take the risk of a lump sum?

Here we present an alternative strategy for taking the lump sum amount, assuming the pension payment amount would be no more than $1,600. It comes from a most unlikely source. It has some stock market risk, but perhaps in a somewhat different manner than most of our readers and clients would otherwise be used to.

We are talking about using some, most or all of the lump sum (in a slow, methodical manner) to perform a very limited type of options trading, referred to as **covered call writing**.

Speculation! Day trading! Blasphemy! No, not quite. In fact, this is just the opposite. In order to fully appreciate what we mean, let's take a step back and describe the essential elements of this process using a completely different context. This may not be the context that most options traders would think of. But that's fine with us. Their goals, actions and procedures are pretty different than what we are going after. This is not meant to frame what they do in a negative light. Speculation and hedging are two valid goals of options trading. But these are not the goals we consider here.

Instead, imagine the simplest business model:



Here we take raw material inputs that we attempted to purchase at the lowest possible price and combine or otherwise work with them using some sort of "process", to arrive at finished goods, ready for sale.

For instance, suppose our business does custom printing. Paper, ink, designs and customer specifications are all inputs. One of our customers, the "*Boys from Q-Division"*, would like a resplendent happy birthday sign created for their boss, chief inspector "*Harry 'Snapper' Organs*". Our printing process produces signs that customers gladly pay us good money for.

Optimally, we would like to purchase the paper and ink at the lowest possible prices. We may also be buying various, pre-drawn graphic designs that we can incorporate into the finished sign, to make it look very professional.

While we would like to sell the finished sign for as high a price as we can, we realize that customers could go elsewhere to other printing shops and look for bargains, or to try and do it themselves. There is a limited window of time to get the job done. If we miss it or get it wrong, the customer may refuse to pay us and we are left with nothing to show for our work.

In this type of business, there are not a lot of raw materials, but still some are present and must be replenished regularly. There is not a highly involved process, but certain procedures do exist and the technical side must be followed closely or else the end result could be defective. We would also like to turn over multiple orders on a regular basis. And if we get a satisfied new customer, perhaps they will come back for more.

Now let's compare the essential elements of this business with covered call writing, even before we define what stock options are and how they are used.

Shares of stock in large US based companies that pay high, regular dividends, will constitute our "raw material" inputs. The "process" is simply grouping up a number of these shares into multiples of 100, based upon our purchase prices and then offering one or more **call option contracts** for sale, at the highest feasible price. Fundamental to our process is trying to sell the option contracts for as high a price as we can get, using up as little cash to buy the "input material" (underlying stock) as possible.

We then pick an option contract expiration date (which we will discuss shortly) nearest to the current date, but that still generates an acceptable level of income. Not only does covered call writing resemble aspects of running a business, there is also something akin to "inventory turnover". Someone who runs their own retail shop may describe how turning over inventory is such an important job. In other words, merchandise that sits on a shelf gathering dust is hurting operational cash flow. If the inventory turns over very quickly, the same investment generates greater overall profit in the course of a year. In covered calls, we can seek to sell contracts as frequently as every week, meaning that the contract has an expiration date of Friday of the current week. The same investment in underlying stock can be put to use in selling call options expiring this week and then when Monday arrives, the same investment could be put to work by selling another call option(s) against the same stock. This helps to generate income on a more frequent basis, from the same initial investment.

At this point, we should take a step back and define options trading in general and covered call writing, in particular. One of the best places to learn about options is on ***The Options Industry Council (OIC)*** Website[9]. We recommend that anyone new to options take a look at this Website before proceeding further. Here is our summary of the most important points we have learned about, concerning options trading.

1. An **option** is a **contract** to buy or sell a *specific* quantity of a *specific* stock (it could be a lot of other things, but we are only concerned with stocks here) within a *specific* time-frame, at a *specific* price. *Have we been specific enough?* The main point here is that these contracts are predefined, are very precise and are standardized. This has greatly facilitated the markets that trade them. Just imagine if they were highly customized. Very few transactions would happen.
2. Contracts have **expiration** dates. When options expire, they no longer have value.
3. There are two types of options: **calls** and **puts**. We only discuss call options here.
4. A call provides the buyer the option, but never the obligation, to purchase a specific quantity of an underlying stock at a specific price, at any time after purchasing the contract, up to the point of expiration. This option is not free. The buyer needs to pay the purchase price, which is also known as the **premium**.
5. If you sell a call option, the premium is the amount of cash that you receive.
6. One option contract typically covers 100 shares of the underlying stock.
7. The premium for an option is really composed of two parts: **Intrinsic Value** plus **Time Value**. Intrinsic value is defined below. Time value depends upon how far away the expiration date is and the market sentiment regarding the probability of a price movement within that period of time. Covered call writers can make money based on both components, but should be ready to focus on time value.
8. It is important to note that brokerage commissions apply and need to be considered. These transaction costs may make some trading prohibitively expensive. It is our opinion that a prerequisite to effective options trading is to have a low cost trading platform. An example of this is the ***Vanguard Brokerage Voyager Select Services Level***. A stock trade (purchase or sell) costs only $2 and each option contract costs $1. Some broker/dealers have moved toward providing

a certain number of free or low cost trades per month. ***Interactive Brokers*** also has a very competitive pricing schedule. The discussion of choosing a brokerage account is beyond our scope.

9. The price at which you are offering the shares of stock specified in the contract is called the **exercise** or **strike** price. If the market value of the stock was to move up beyond the strike price prior to expiration of the contract, the call option is said to be "**in the money**". What this means is that the buyer has intrinsic value at that point (the amount of intrinsic value is the amount by which the current market price is above the strike price). If a buyer were to exercise the option contract to purchase your shares, they would be entitled to pay you no more than the strike price. And guess what? You would be obligated to sell at that price. No ifs, ands, or buts. This is also called an **assignment**. Seller and buyer never meet or even know of each other. All of this is handled in a very automated process by the intermediary, the ***Options Clearing Corporation*** (OCC).
10. Most of the time, options expire worthless. *Oh dear! Oh shame!* No, how about *Oh, wonderful?* Selling a call option provides an opportunity for someone to express a bullish sentiment and speculate on the near term, future price movement of a stock. Maybe they'll be right, but often, they are not. As the covered call writer, you are supplying the stock that enables them to speculate. But you are not the one speculating. They are. You are paid for providing the shares. This is why the activity is called "covered call writing". It means that the call contracts are being sold by someone who already owns the stock to cover the position (deliver to the buyer in case of exercise). Not owning the stock but selling call option contracts is termed selling "**naked calls**". This is an extremely risky proposition which we NEVER recommend.
11. Much of the income in covered call writing is made when selling options that are **near the money**. This means that the strike price is close to the current market price. If we buy a stock for $10, see it move up to $12 and then sell covered calls with a strike price of $11, the call option price (premium) would usually be the $1 amount that it is in the money for, plus some time value. Let's assume this is 20 cents. If we find a buyer at this $1.20 price for our 100 shares, we would expect to get $120 minus commission. Let's say this is $117 net. The cash should be deposited into our account by the next day, since option trades settle in one business day. If the option is not exercised while it is in the money and the price of the stock falls to below $11 at expiration, the option will expire worthless. While the buyer on the other side can exercise at any time up to expiration, there is the uncertainty over whether the price of the stock will continue to go up. If so, there is value in waiting. On the other side of the coin, we may buy that stock for $10, see it fall to $9.50 and sell the call option with a strike price of $10. In this case, there is no intrinsic value, only time value. The "market" may say this is only worth 15 cents. Multiplying by 100 shares and subtracting commission may

mean we wind up with only $12 of income. Option pricing is very dynamic and can make stock price movements look like watching paint dry. But remember, we are not buying the options, only selling them.

12. It would be necessary to apply for option trading privileges for your brokerage account, since this level of security was probably not given to you by default when your account was opened. To perform covered call writing, the lowest level of option trading privileges is all that you need, since it is considered an income generation strategy and not for speculation. You should NOT need a margin account, either.
13. Active and robust options trading does not exist for every stock. A useful tool for determining if a lot of options activity exists for a particular stock, is looking at quotes on the OIC Website, called an **Options Chain**. Contracts are frequently offered with strike prices that go up in 50 cent increments. This is not always the case. Some stocks may increment by $1 or $5. The issue is that the more finely "grained" the strike price, the better able we would be to match up to our purchase price for the stock, recent market movements, as well as what buyers are looking for.

Next, here is a brief overview of the underlying process that is used to generate income.

1. We recommend that this activity occurs inside an IRA, since there will be no need to keep track of capital gains/losses on the underlying stocks. The problem with doing a lot of trading is that it generates a lot of paperwork if you do it in a taxable account.
2. The process begins with purchasing some underlying stock. We do not recommend just any stock. The major characteristics we look for are: US large-cap, dividend paying companies, where the current dividend yield is higher than the yield on 10 year US Treasury bonds, especially above 2.5%. The reasoning behind the dividend is that in case the stock is not "called away" from us, we will still be hanging on to it. The amount of the dividend helps to cushion drops in the price, although it will not be enough to cushion all price drops. We also like to review the options chain and verify that call options against this stock are actively traded, with weekly expiration dates and using smaller price increments, such as 50 cents. Another characteristic is that the stock exhibits some price volatility on an intra-day basis. In other words, there is some movement in price during the day and we make use of that movement.
3. After the stock(s) have been identified, we set up **limit orders** to purchase them. Depending upon your trading costs and the stock's per share price, you may like to place orders for 100 shares or even fewer (unless the stock's price is so low that a 200 or 300 share purchase only uses a few thousand dollars). This is where cheap trading comes in handy. Buying 50 shares at a time can be cumbersome, but it

does offer a variety of prices. If trading costs are relatively high, this may not be a good idea. A limit order is distinguished from a **market order** in that a limit price is set. The order will not fill unless it can be executed at that price or better (lower). You can specify the duration of the order as being for only that day for example, or **good till canceled** (GTC). Your broker may have other details to consider. The main issue here is having purchased shares of the stock when the price is a little below current market. Oftentimes, the level of variability in the intraday price of a stock seems higher in the first hour of trading, as loads of information from the night before get evaluated and acted upon by market participants.

4. A stock trade settles in three business days. If you purchase some shares and see the price go up, you may be tempted to sell right away. Depending upon your broker, you may get a slap on the wrist. Buying at 9:30 AM EST and selling at 11:00 AM EST is day trading. We are definitely NOT recommending anyone do day trading. What is different about options trading is that even though the stock trade will not settle for three business days, you can immediately sell a call option contract against 100 shares of the stock you just bought.
5. With new shares in your account, you begin to check out the prices for the call option contracts to sell. This is where the uncertainty really begins. You may need to wait a minute, a day or a week. It all depends upon the price movement of the underlying stock after you purchased it, the activity in the options market and your own objectives. Having a system, such as focusing on the amount of income generation you are targeting each month, works well. If it feels as though you don't see the “big money” and you are sweeping up loose change here and there, then perhaps you are beginning to see the true usefulness of this strategy. It is not meant to be a get rich quick scheme.
6. You sell the option contracts (one per every 100 shares owned), trying to get the highest price possible that someone will pay. This sale should also be a limit order. You will find yourself going back and forth with changing the price at which you will accept. A bid and ask price will be visible from various options markets. You will also track what is happening to the underlying stock price. Please keep in mind that depending on your broker, you may have a delay in getting pricing data. This may be the trade-off for getting those cheaper trades. You can use free Websites, such as Google Finance, to get a stock quote as often as needed during the day. Please keep in mind that every single penny counts! Often, it is the final one cent decrease in your limit price that will cause the option to get sold (so you can get paid). You will not be charged extra for changing your limit orders frequently, to lower your asking price. It is typical that you will want to start off on the high side of a price and work your way down.
7. We recommend focusing on the nearest expiration dates, such as the current Friday. Just as in our business model analogy, you would like to see the most

rapid turnover. If the option expires worthless on Friday, then you're back on Monday selling another one with that new week's expiration date. If the stock is called away from you, no problem. You will have cash in your account to buy more stock, either that same one or another. Your broker's system may give you warning messages about using **unsettled funds** for your next purchase (the sale after the call was exercised is still in process), but this should not pose a problem.

8. After purchasing a stock the price may, of course, go down. When this happens, the strike price chosen for the call option to be sold, gets further away from the current market price and in the wrong direction. If the option will already be out of the money, it may now be further away. The option's value may drop to the point of being nearly worthless, even with the price difference between the current market and the strike being only $1, $1.50 or $2. As we have mentioned, option pricing is very dynamic. One method of dealing with this is to purchase additional underlying stock at the new, lower price. This will lower the average cost per share. Suppose your average cost was $26.20. The current market price is $26.40. You set your strike price to $26.50, satisfied to more than break even if the stock were to go up by a tiny amount. Instead, it goes straight down to $25.80. You find that no one wants to buy your options with a $26.50 strike. So you purchase additional shares and bring your average cost to just under $26. This is called **averaging down**. You cancel the previous option sale and enter a new one for more contracts, since you now own more shares. This time you change the strike price to $26. You would only break even now, on an assignment. However, you still have made the option income.

We can only attempt to scratch the surface of covered call writing in this article. Our final objective is to tie this back to retirement income. We don't recommend purchasing stocks with the entire lump sum immediately. We recommend starting off very slowly. The reason for this procedure is to generate your desired income goal, using the least amount of your lump sum invested in stocks.

What should your monthly income goal be?

In our analysis of actual option trading for a $250,000 lump sum, the income target was twice the $1,600 theoretical pension payment alternative, or $3,200 per month.

There are ups and downs to the stock market. You may generate your monthly income goal in two weeks of one month and then have difficulty getting even half of that in the entire second month. Stay patient. Actually, a sideways trending stock market is ideal for an options trader. This involves some upward movement only to see the stock settle back down again. While this may be frustrating to a long term investor who is paying a bit too much attention to their portfolio, this type of price action is excellent for the options trader.

While an increasing stock market is also desirable, we should pay some attention to the more inflated prices being paid to buy back the same stocks again and again. While this is not a major issue, it is something to be aware of.

However, it is in market corrections and bear markets, that this entire process may break down, though perhaps not entirely. Some stocks move out of favor, or their industries face strong headwinds. An example would be the extent to which oil company stock prices are influenced by the price of oil.

This is the main reason why we stress that only large-cap, higher dividend paying stocks be used for covered call writing. If we are holding on to a stock because it has gone down in value, we would at least like to make up for part of this drop by collecting that quarterly dividend. We recommend that your brokerage account be set to receive dividends in cash only. Also, larger capitalization stocks usually represent far stronger and resilient companies, than small-cap stocks. We are not interested in the growth prospects of these companies, since this is not a true buy and hold strategy.

The stocks of the following few companies provide a starting point. They are listed in no particular order of preference, along with their ticker symbols:

Chevron Corporation	(CVX)
Cisco Systems, Inc.	(CSCO)
Coca-Cola Co.	(KO)
AbbVie, Inc.	(ABBV)
Exxon Mobil Corp.	(XOM)
Intel Corp.	(INTC)
AT&T, Inc.	(T)
Verizon Comm. Inc.	(VZ)

The objective is to set the strike price above your average cost per share, including commissions. By expiration, the stock's actual market price may be higher, in which case it will be called away from you, at the strike price. You will have gain on the stock, as well as the income from selling the call. But you will have given up the potential for an even greater gain on the stock. This gain goes to the option buyer in this instance. This trade-off is worthwhile, given how often options expire worthless.

If the strike price was set above your average cost per share, but the market price never makes it to that point by expiration, the option expires worthless. You have the option income and you are still holding on to the stock. Selling call options does not involve the risk of loss. But it is holding on to the underlying stock, that exposes you to the risk of loss. This is unavoidable. The objective is to try and manage the risk, by investing only the amount of the lump sum that is necessary to generate your desired level of income.

Periodically, it may be necessary to sell the underlying stock for less than what we paid for it, simply because it has gone down enough in value. We could do this by setting a strike price below our average cost per share. This should be done carefully, in a conscious attempt to close a stock position, when you feel you have accumulated too many shares or are uncomfortable with holding on in the hope of a recovery in its price.

Back to our retirement pension scenario, we have put together the following estimates.

Original Age at Start of Strategy	55
Original Monthly Pension Plan Payment Available	$1,600
	or
Original Lump Sum Offered as Alternative	$250,000
Expected Shrinkage in 15 Years	20%
Expected Potential Value After 15 Years	$200,000
Average Monthly Income Generated	$3,200
Income Needed to Offset Missing Pension Payment	$1,600
Average Monthly Excess Income	$1,600
Conservative Estimate of Interest Earned on Excess	0.25%
Total Excess Income Collected Over 15 Years	$293,437
Total of Shrunken Lump Sum Plus Excess Income	$493,437
Age at End of Strategy	70
Holding Interest Rates Constant, Value of Annuity Payment that is Possible at the new Age (100% J&S) as Shown by ImmediateAnnuities.com	$2,378
Percentage Increase Over Original Pension Amount	**49%**

Each was optimistic from the standpoint of the monthly pension and pessimistic from the standpoint of our options strategy. For example, the $1,600 pension amount at age 55 (100% joint and survivor benefits) may be overstated by $100-$200. It is the $250,000 lump sum amount, which is considered fixed in this analysis. A pension plan may well offer much more than taking the lump sum and annuitizing it. For example, ***ImmediateAnnuities*** reported that at age 55 (with 100% J&S), a $250,000 premium will only buy a $958 monthly payment (in 2016).

With our covered call writing strategy, we have been averaging closer to $4,000 per month, although this has only been tested for under one year. We feel that $3,200 as a monthly average, or twice the pension payment, is achievable in the long run. During this time, some, most, or even all of the lump sum, will be invested in these dividend paying stocks. This is where sticking to a system of focusing on your income goal and minimizing unnecessary trading, may prove helpful. In our testing, we kept "pushing the envelope" to see how much income could be produced. While we were able to get to over $1,000 per week for eight straight weeks, this gradually resulted in the entire lump sum getting invested. This is not the most efficient method and we recommend avoiding it. Instead, stick to reaching your predefined monthly income goal.

Your input time and effort commitment should also be judged. Two hours a day, for about ten hours per week, was our average. A more efficient approach might be able to cut this number down somewhat. But any newcomer should not attempt to focus on speed of execution. It is the end result of achieving your income goal with the least amount of capital committed, that is most important.

Our further recommendation is that the average (expected) $3,200 monthly income be split into two categories or "buckets". In the first, we merely replace the $1,600 pension plan monthly payment that we gave up, in order to get the lump sum. So we are no worse off. Then we move the OTHER $1,600 to a money market or savings account, free from any stock market risk.

To be on the pessimistic side of estimating our results, we assumed that this "excess income" sitting in the savings account will earn a miserly 0.25% of annual interest. This analysis was carried out for a fifteen year period, although our real life trial was more like 26 weeks. In total, the average $1,600 excess income amount per month, accumulated over 15 years, would end up exceeding $290,000.

To continue on the pessimistic side, we assume that even with the dividends bolstering the lump sum, we will still be unable to grow, or even to maintain, its value over time. In fact, for purposes of our analysis, we assume that the lump sum shrinks by 20% over the next 15 years, to end up at $200,000.

So after a decade and a half, we have the remainder of our lump sum plus the excess income in a savings account. Our estimate ends up at slightly more than $493,000. However, now we happen to be age 70. We decide we would like to do more productive things with the remainder of our lives, maybe going to the casino and race track instead of covered call writing (of course, we're kidding). But what if we no longer wanted the "burden" of generating option income? What if we take this $493K to an insurance company and annuitize it?

We have a nominal amount which is more than what we started with. We are 15 years older. For purposes of this analysis, we assume that interest rates in the future are exactly where they presently are. The probability is that interest rates in fifteen years will be higher and not lower (or the same). Going back to the ***ImmediateAnnuities*** Website, we plug in the numbers and get back $2,378 as the best monthly annuity payment available. This represents almost a 50% increase over the pension plan amount of $1,600 that we started our analysis with. It is like getting a one time inflation adjustment.

We should also briefly demonstrate some mechanics of the covered call writing process with an actual example. This is shown below, as an addendum.

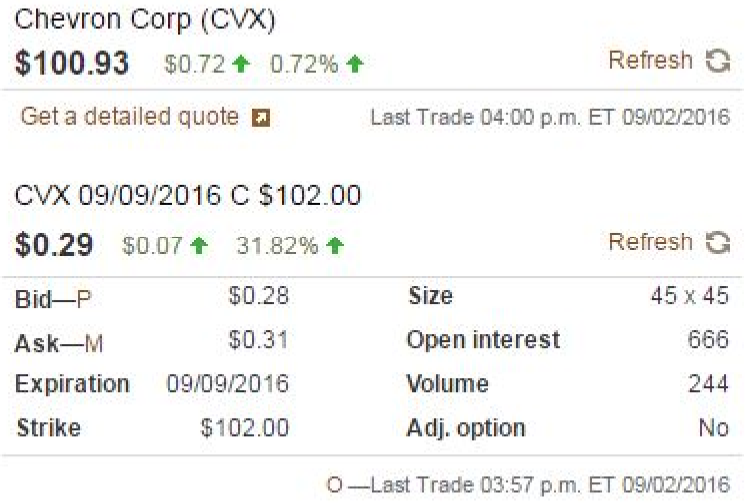
The focus of our analysis has been on rethinking retirement income in an era of very low interest rates. It's not about option trading, per se.

Being presented with a lump sum pension option versus a monthly check, is a difficult question to answer today. Handle it carefully. Seek out professional, unbiased help as needed. Understand that you will not be able to generate the same amount of income in "perfect safety". But compare apples to apples, by using 100% J&S amounts when analyzing your choices.

If your assets are few, it is not necessarily your monthly pension check that should be chosen. It is probably rethinking whether you can retire early at all. Many will not be able to. We have previously covered how labor force participation among seniors is likely to be going up over the next twenty years. So maybe skip both the lump sum and the check? Or maybe not. What about waking up from the lethargy of not planning your finances and instead, taking an active role, seeking out help as needed? ***Those who fail to plan...plan to not be bothered, because they're so busy working forever?***

Income generation in a low interest rate environment is possible. Covered call writing is one of the best strategies we have seen, although it is not the only one. Our analysis attempted to be realistic. We selected some slightly pessimistic outcomes simply to demonstrate our points. But please keep in mind the limitation of that "guaranteed income for life" pension check. Unless it is inflation adjusted, it will not be "guaranteed purchasing power for life".

Let's look at a specific stock that meets our criteria for covered call writing. Chevron is a large oil company that pays a dividend that is currently more than 4%. It has ups and downs based upon the price of oil, which may make it more or less attractive, based upon your disposition. Options are very actively traded for Chevron. There are weekly expiration dates, although depending on the strike price, we may not see the 50 cent increments we mentioned above. The below screen shots were taken from a ***Vanguard Brokerage Services*** account[10]. While another broker's screens may look different, the essential elements will all be present.



Chevron Corp (CVX)

$100.93 $0.72 ↑ 0.72% ↑

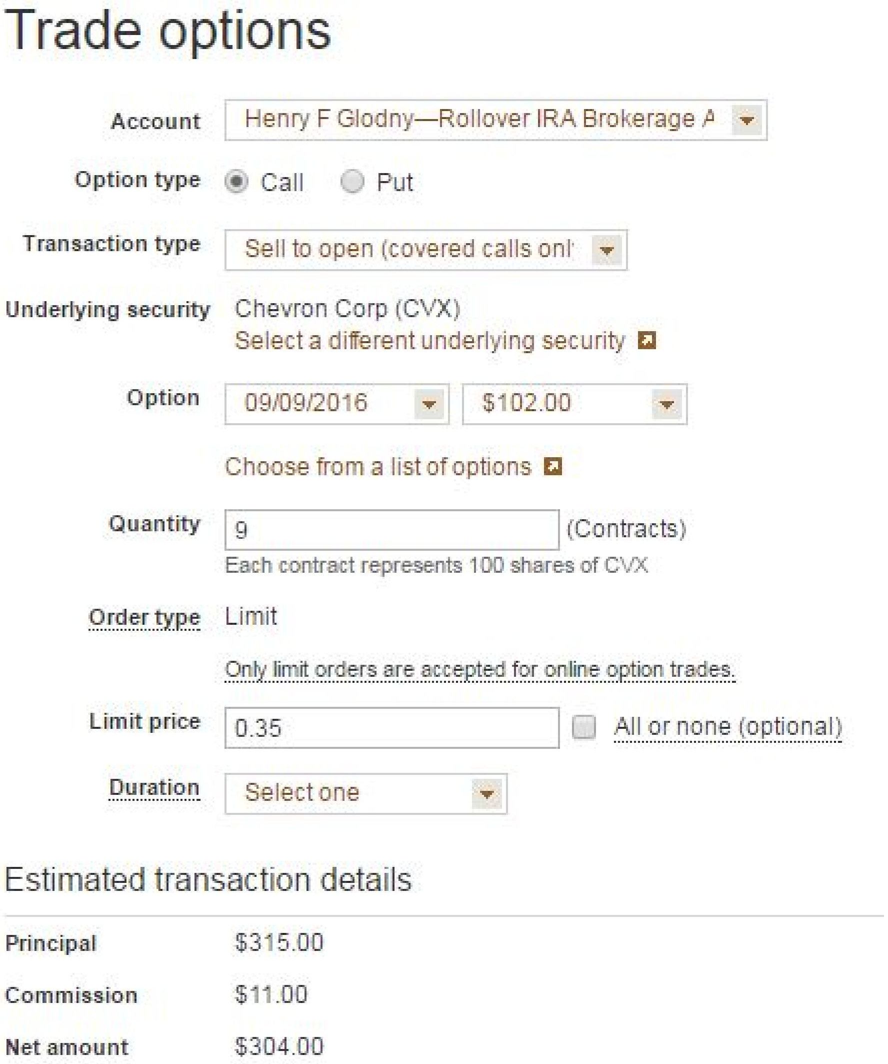
Last Trade 04:00 p.m. ET 09/02/2016

CVX 09/09/2016 C $102.00

$0.29 $0.07 ↑ 31.82% ↑

Bid—P	$0.28	Size	45 x 45
Ask—M	$0.31	Open interest	666
Expiration	09/09/2016	Volume	244
Strike	$102.00	Adj. option	No

O —Last Trade 03:57 p.m. ET 09/02/2016



Trade options

Account	Henry F Glodny—Rollover IRA Brokerage A
Option type	● Call ○ Put
Transaction type	Sell to open (covered calls onl
Underlying security	Chevron Corp (CVX) Select a different underlying security
Option	09/09/2016 $102.00 Choose from a list of options
Quantity	9 (Contracts) Each contract represents 100 shares of CVX
Order type	Limit Only limit orders are accepted for online option trades.
Limit price	0.35 □ All or none (optional)
Duration	Select one

Estimated transaction details

Principal	$315.00
Commission	$11.00
Net amount	$304.00

The current stock price is displayed as $100.93. Please keep in mind any delays that your broker has in showing quotes. Opening another browser window to view ***Google Finance*** or ***Yahoo Finance***, may be useful.

Note the volatility of the displayed option price, in bold. This is the last transaction reported, at $0.29. This represents the sales price of the call option, on a per share basis. While 7 cents may not seem like a lot, this represents almost a 32% increase, that day. Bid and ask prices followed by characters denote the specific option trading market being reported. There are a number of markets on which equity options are currently traded. The expiration date shown means that the call option will expire at close of trading on that date. The strike price shown is $102. Of course, this is absolutely essential. The buyer of the call options will profit if the market price of Chevron exceeds the strike price at or before expiration. For our purposes, we would like to make sure it is set in accordance with our average cost per share of the underlying stock, as well as with the income potential for selling the options.

On the second screen, we see an actual trade about ready to take place. Nine contracts, representing 900 shares of Chevron, are about to be placed for sale. The limit price of $0.35 shown represents the per share amount. An order duration remains to be chosen, which is typically either the remainder of that day or 60 days **Good-til-Canceled**.

For our purposes, we are bypassing a lot of the technical information and focusing on the income generation aspects. So let's examine the income we we looking to generate:

(9 contracts x 100 shares per contract x $0.35 per share)
minus
Commissions of $2 plus $1 per contract
equals
$304.00

Will we realize this amount? It depends. As we have mentioned, option prices are very dynamic. We recommend starting out on the higher side and gradually working down to a price that is accepted.

Once the order is submitted, it can be viewed using whatever Order Status capabilities your broker provides. You can then modify your limit price, even increasing it. Please note that if your limit price is too low, it may be viewed as a “bargain” and will automatically be snapped up by the processes waiting to buy at lower prices. This is why it is so important to look at the market first and judge based upon bid, ask and recent completed transactions.

You will likely not be able to change the strike price using the change order functionality of your broker. At that point, it would be best to just cancel the open order and re-enter it from scratch. The topic of strike price is very important. Here we see the delicate interplay among your average cost per share, the strike price you set and the current market price of the stock.

At a strike price of $102, the current market price of $100.93 is $1.07 out of the money. As a result, these options are not usually worth very much. Only their time value exists (i.e. there is no intrinsic value for an out of the money option).

If we purchased the stock at $102, we may just be looking to break even on the stock and to collect the option income. In fact, this is one aspect of our strategy. However, we need to keep transaction costs in mind at all times. We may also accept a loss periodically, if we want to lower the amount of exposure we have to stocks and we think this particular stock is headed down.

We may just hold for the long term and focus on receiving the dividends, while having the stock only periodically "called away" (as the options go in the money and an assignment occurs). An important point to remember is to make sure we own the stock on the so called **record date**, when the corporation closes its books on who the shareholders of record are. These are the ones who actually receive the dividends. It is technically possible for an in the money option to get exercised well before the option expiration date, in order for the buyer to snatch the dividends. However, this would need to happen before the **ex-dividend** date of the stock.

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https://investor.vanguard.com/home/

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